

ORIGINAL




0000061303

MEMORANDUM

30

TO: Docket Control

FROM: Ernest G. Johnson 
Director
Utilities Division

DATE: September 15, 2006

RE: STAFF REPORT FOR THE ARIZONA-AMERICAN WATER COMPANY, INC. APPLICATION FOR AUTHORITY TO INCUR LONG-TERM THROUGH ITS AFFILIATE, AMERICAN WATER CAPITAL CORPORATION (DOCKET NO. WS-01303A-06-0283)

Attached is the Staff Report for Arizona-American Water Company, Inc.'s application for authority to incur long-term debt through its affiliate, American Water Capital Corporation and for authorization of payment obligations to the City of Tolleson. Staff recommends approval of the proposed financing.


EGJ:PMC:tdp

Originator: Pedro M. Chaves

Arizona Corporation Commission

DOCKETED

SEP 15 2006

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AZ CORP COMMISSION
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2006 SEP 15 A 10:50

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Service List For: Arizona-American Water Company, Inc.
Docket No. WS-01303A-06-0283

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

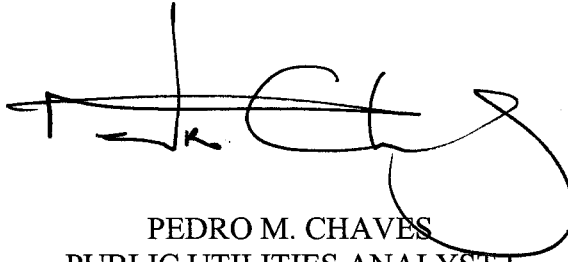
**ARIZONA-AMERICAN WATER COMPANY, INC.
DOCKET NO. WS-01303A-06-0283**

**APPLICATION FOR AUTHORITY TO
INCUR LONG-TERM DEBT**

SEPTEMBER 15, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona-American Water Company, Inc., Docket No. WS-01303A-06-0283 is the responsibility of the Staff members listed below: Pedro M. Chaves is responsible for the review and financial analysis of the Company's application. Jian Liu is responsible for the engineering and technical analysis.



PEDRO M. CHAVES
PUBLIC UTILITIES ANALYST I



JIAN LIU
UTILITIES ENGINEER

EXECUTIVE SUMMARY
ARIZONA-AMERICAN WATER COMPANY, INC.
DOCKET NO. WS-01303A-06-0283

Arizona-American Water Company, Inc. ("Arizona-American" or "Applicant"), a Class "A" utility with its principal office in Phoenix, Arizona, filed an application for authority to incur long-term debt through its affiliate, American Water Capital Corporation ("AWCC") on April 26, 2006. The application also requests authorization, to the extent necessary, for payment obligations to the City of Tolleson.

The Applicant asks that the Commission authorize it to borrow an amount not to exceed \$165.45 million in new funds from AWCC. The Applicant plans to use \$158.45 million to pay off maturing debt and \$7.0 million to fund new capital projects. In addition, the Applicant requests Commission approval of an existing \$8.56 million obligation to the City of Tolleson. Arizona-American is the successor in interest to Sun City Sewer as the purchaser of sewage treatment services from the City of Tolleson.

Arizona-American's existing capital structure consists of 8.5 percent short-term debt, 58.6 percent long-term debt, and 32.9 percent equity. The proposed debt issuance and refunding would increase outstanding debt by \$7.0 million and result in a pro forma capital structure composed of 8.1 percent short-term debt, 57.7 percent long-term debt and 34.2 percent equity.

The Applicant's times interest earned ("TIER"), debt service coverage ("DSC") and cash coverage ("CCR") ratios by the year ended 2005 were 0.52, 2.05 and 2.06, respectively. Staff's pro forma TIER, DSC and CCR ratios resulting from issuance of the proposed debt are 0.46, 1.81 and 1.82, respectively. TIER results indicate that operating income would suffice to cover interest expense in the short term, but not in the long term. Nonetheless, DSC results show that operating cash flow is sufficient to cover both principal and interest payments on short-and long-term debt obligations.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is lawful and within Arizona-American's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize Arizona-American's request to borrow an amount not to exceed \$165.45 million in new funds from AWCC for the purposes described herein.

Staff further recommends that the Commission approve Arizona-American's \$8.56 million obligation to the City of Tolleson.

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Introduction

On April 26, 2006 Arizona-American Water Company, Inc. ("Arizona-American" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission") requesting authority to incur long-term debt through its affiliate, American Water Capital Corporation ("AWCC"). The Applicant also requested approval, to the extent necessary, of an obligation to the City of Tolleson.

Public Notice

On June 23, 2006, the Applicant filed an affidavit of publication verifying public notice of its financing application. The Applicant published notice of its financing application in the *Mohave Valley Daily News* on May 15, 2006, in the *Arizona Business Gazette* on May 18, 2006, and in the *Nogales International* on May 19, 2006. The *Mohave Valley Daily News* is a six times weekly newspaper published in the City of Bullhead, County of Mohave, Arizona. The *Arizona Business Gazette* is a newspaper of general circulation in the county of Maricopa, Arizona. The *Nogales International* is a newspaper of general circulation in the County of Santa Cruz, Arizona. The affidavit of publication is attached along with a copy of the Notice.

Background

Arizona-American is a Class "A" Arizona public service corporation providing water and wastewater services in portions of Mohave, Maricopa and Santa Cruz counties. The Applicant provides utility service to approximately 97,000 water customers and 47,000 sewer customers in Arizona.

Arizona-American's principal business office is located at 19820 North Seventh Street, Suite 201, Phoenix, Arizona 85024.

Arizona-American currently has three rate cases in progress for the following districts: (1) Mohave Water and Wastewater, Docket No. WS-01303A-06-0014, (2) Anthem Water and Anthem/Agua Fria Wastewater, Docket No. WS-01303A-06-0403, and (3) Sun City Wastewater and Sun City West Wastewater, Docket No. WS-01303A-06-0491.

Purpose of the AWCC Financing

The Applicant asks approval of the Commission to borrow \$165.45 million from AWCC for the purpose of paying off two promissory notes that mature in November of 2006 (totaling \$158.45 million¹) and to fund \$7.0 million of new capital projects.

¹ One note is for \$154,948,119 (Decision No. 64002, dated August 30, 2001) and the other of \$3.5 million (Decision No. 63586, dated April 24, 2001).

Description of Proposed AWCC Financing

Arizona-American anticipates a ten-year interest-only loan of \$165.45 million and an interest rate not to exceed 6.5 percent per annum for loans from AWCC. All principal is due at maturity. The actual interest rate will be determined by market conditions at the time of the transaction. There are no expected financing costs or issuance fees. In addition, AWCC has no coverage ratio requirements for Arizona-American.

Obligation to the City of Tolleson

The Applicant also requests Commission approval of an \$8.56 million obligation ("Obligation") to the City of Tolleson ("Tolleson"). The Applicant's request for approval of the existing Tolleson obligation is to remove uncertainty as to whether authorization is needed or already exists. Need for approval of the Tolleson obligation is unclear due to the following events. As Arizona-American states in its application, "Arizona-American is the successor in interest to Sun City Sewer as the purchaser of sewage treatment services from the City of Tolleson under a Sewage Treatment and Transportation Services Agreement ("Services Agreement"). To finance the Facilities needed to provide service under the Services Agreement, the City of Tolleson has issued \$8.56 million in bonds. Payments for the bonds are made from revenues received under the Services Agreement and Arizona-American guarantees these payments."

The Obligation was previously guaranteed by Citizens Utilities Company ("Citizens") in the year 1998. Subsequently, Arizona-American acquired the water and wastewater assets and the Certificates held by Citizens in Arizona. The Commission authorized the acquisition in Decision No. 63584, dated September 26, 2000. Decision No. 63584 approved the transfer of assets and recognizes in the description of the transaction that Arizona-American would assume liabilities for contracts. However, Decision No. 63584 is silent regarding approval of the terms of transaction, and the term "assets" is undefined. Thus, uncertainty exists regarding whether Arizona-American has Commission authorization for Obligation.

Financial Analysis

Staff's analysis is illustrated on Schedule PMC-1. Column [A] reflects Arizona-American's historical financial information for the year ended December 31, 2005.² Column [B] presents pro forma financial information that modifies Column [A] to reflect the effect of the AWCC debt proposed by the Applicant assuming a 6.5 percent annual interest rate and a 10-year amortization.

² Includes the Tolleson Obligation.

TIER, DSC and CCR

Times interest earned ratio ("TIER") represents the number of times earnings cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not mean that debt obligations cannot be met in the short term.

Debt service coverage ratio ("DSC") represents the number of times internally generated cash will cover required principal and interest payments on short-term and long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default.

Cash Coverage Ratio ("CCR") represents the number of times internally generated cash covers required interest payments on short-term and long-term debt. A CCR greater than 1.0 means that operating cash flow is greater than interest expense.

Schedule PMC-1, Column [A] shows that for the year ended December 31, 2005, Arizona-American had a 0.52 TIER, a 2.05 DSC and a 2.06 CCR before recognition of any additional debt. These results decline to a 0.46 TIER, a 1.81 DSC and a 1.82 CCR under the scenario described above for Column [B].

As evident in Columns [A] and [B], Arizona-American has unsatisfactory TIER results. The Applicant's TIER results reflect that operating income would suffice to cover interest expense in the short-term, but not in the long term. Conversely, DSC results indicate that Arizona-American will be able to meet all obligations with cash generated from operations. Thus, operating cash flow is sufficient to cover both principal and interest payments on short- and long-term debt obligations.

Capital Structure

At December 31, 2005, Arizona-American's capital structure consisted of 8.5 percent short-term debt, 58.6 percent long-term debt, and 32.9 percent equity (Schedule PMC-1, Column [A]). Issuance of the proposed AWCC debt would result in a capital structure composed of 8.1 percent short-term debt, 57.7 percent long-term debt and 34.2 percent equity (Schedule PMC-1, Column [B]).

On March 21, 2006, Arizona-American received an injection of \$35 million in new equity. The effect of this equity injection on its equity position was partially offset by a goodwill write-off of \$24.4 million.

Engineering Analysis

The Staff Engineering Report is attached. Staff reviewed the material cost estimates of the new projects. Staff concludes that Arizona-American's \$7 million cost estimate for the proposed capital plan appears reasonable. Staff makes no "used and useful" determination in this proceeding. Treatment of the proposed plant improvements for rate-making purposes is deferred to a future rate proceeding.

Compliance

There are no compliance issues with Arizona-American Water Company, Inc.

Conclusion and Recommendations

Staff concludes that authorization of the \$8,560,000 Tolleson Obligation is appropriate to clarify any ambiguity regarding the existence of Commission authorization.

Staff concludes that the estimated costs associated with the new capital projects appear to be reasonable.

Staff concludes that issuance of the proposed AWCC debt financing not to exceed \$7,000,000 to fund new capital projects and not to exceed \$158,450,000 to pay off maturing debt is within Arizona-American's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize Arizona-American's request to borrow an amount not to exceed \$165.45 million in new funds from AWCC for the purposes described herein.

Staff recommends that the Commission approve Arizona-American's \$8,560,000 City of Tolleson Obligation pertaining to the Services Agreement as successor in interest to Sun City Sewer.

Staff recommends authorizing Arizona-American to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.

Staff further recommends that one copy of the executed loan documents be filed with Docket Control within 30 days of execution.

FINANCIAL ANALYSIS

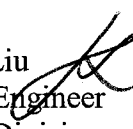
Selected Financial Information Including Immediate Effects of the Proposed Debt

		[A] <u>12/31/2005</u>		[B] <u>Pro Forma</u>	
1	Operating Income	\$ 6,906,330		\$ 6,906,330	
2	Depreciation & Amort.	14,695,302		14,695,302	
3	Income Tax Expense	(1,898,318)		(1,898,318)	
4					
5	Interest Expense	9,576,937		10,844,061	
6	Repayment of Principal	14,857		14,857	
7					
8					
9	TIER				
10	[1+3] ÷ [5]	0.52		0.46	
11	DSC				
12	[1+2+3] ÷ [5+6]	2.05		1.81	
13	Cash Coverage Ratio				
14	[1+2+3] ÷ [5]	2.06		1.82	
15					
16					
17					
18	Short-term Debt	\$30,017,995	8.5%	\$30,017,995	8.1%
19					
20	Long-term Debt	\$207,317,395	58.6%	\$214,317,395	57.7%
21					
22	Common Equity	\$116,249,739	32.9%	\$126,884,955	34.2%
23					
24	Total Capital	\$353,585,129	100.0%	\$371,220,345	100.0%
25					
26	[A]: Based on 2005 financial statements.				
27	[B]: Column [A] inclusive of the proposed financing, 2006 equity infusion and goodwill write-off.				

MEMORANDUM

DATE: September 6, 2006

TO: Pedro M. Chaves
Public Utilities Analyst I
Utilities Division

FROM: Jian W. Liu 
Utilities Engineer
Utilities Division

RE: Arizona-American Water Company
Docket No. WS-01303A-06-0283 (Financing)

Introduction

Arizona-American Water Company ("Arizona-American" or "Company") presently provides utility service to approximately 97,000 water customers and 47,000 sewer customers in Arizona. The Company is an Arizona public service corporation providing water and wastewater services in portions of Mohave, Maricopa and Santa Cruz counties. Arizona-American's principal business office is located at 19820 North Seventh Street, Suite 201, Phoenix, Arizona 85024.

Financing Application

On April 26, 2006, the Company filed an application with the Arizona Corporation Commission ("Commission") requesting authority to incur long-term debt through its affiliate, American Water Capital Corporation ("AWCC") in the amount of \$165.45 million.

The purpose of this loan is to pay off two promissory notes that mature in November of 2006 (totaling \$158.45 million¹), as well as obtain \$7.0 million to fund new capital projects.

Engineering Analysis For \$7.0 Million In New Capital Projects

The Company submitted two new capital projects to support its application. Expansion for its Mohave Wastewater Treatment Plant in Mohave County, and its Verrado Wastewater Treatment Plant Phase 2 expansion in Maricopa County.

¹ One note is for \$154,948,119 (Decision No. 64002, dated August 30, 2001) and the other of \$3.5 million (Decision No. 63586, dated April 24, 2001).

Arizona-American is planning to expand for its Mohave Wastewater Treatment Plant by 250,000 gallons per day to meet projected demands and required wastewater treatment standards. The Wastewater Treatment Plant currently has a design capacity of 250,000 gallons per day. The projections of new hookups show the existing plant capacity will be exceeded by early 2008. This project will include a pre-packaged 250,000 gallons per day treatment facility (matching the existing plant), solids handling facility, expanded blower building, sitework, electrical, and foundation, etc. The estimated total project cost is \$2,763,000.

The second project is Verrado Wastewater Treatment Plant Phase 2 expansion. The Verrado Wastewater Treatment Plant has an existing capacity of 450,000 gallons per day. The projected flow will reach this existing capacity in the summer of 2007. Proposed expansion will increase treatment plant capacity from 450,000 to 1,160,000 gallons per day, which will meet projected demands until 2011. The estimated total project cost is \$4,910,000.

Compliance

Arizona Department of Environmental Quality (ADEQ) Compliance

ADEQ has indicated the Company is in compliance with ADEQ regulations.

Arizona Corporation Commission (ACC) Compliance

According to the Utilities Division Compliance Section (Compliance Section Email dated May 9, 2006), the Company has no outstanding compliance issues with the ACC.

Conclusion

Staff concludes that the proposed plant additions are reasonable and the estimated total project costs for the two new capital projects referenced above are reasonable. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purposes in the future.

BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

2006 JUN 23 A 9:33

AZ CORP COMMISSION
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APPLICATION OF ARIZONA-AMERICAN
WATER COMPANY, INC., AN ARIZONA
CORPORATION, FOR AUTHORITY TO
INCUR LONG-TERM DEBT THROUGH ITS
AFFILIATE, AMERICAN WATER CAPITAL
CORPORATION

DOCKET NO. WS-01303A-06-0283

ARIZONA-AMERICAN WATER
COMPANY'S
NOTICE OF FILING
PROOFS OF PUBLICATION

Arizona-American Water Company hereby files in the above-referenced matter the following three proofs of publication:

1. Arizona Business Gazette – May 18, 2006;
2. Nogales International – May 19, 2006; and
3. Mohave Valley Daily News – May 15, 2006.

RESPECTFULLY SUBMITTED on June 22, 2006.

RECEIVED

JUN 23 2006

AZ CORP COMM
Director Utilities



Craig A. Marks
Corporate Counsel
Arizona-American Water
19820 N. 7th Street
Suite 201
Phoenix, Arizona 85024
(623) 445-2442
Craig.Marks@amwater.com

Original and 13 copies filed
on June 22, 2006, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies of the foregoing mailed
on June 22, 2006, to:

Lyn Farmer
Chief Hearing Officer
Hearing Division
Arizona Corporation Commission
1200 West Washington St.
Phoenix, Arizona 85007

Ernest Johnson
Director
Utilities Division
Arizona Corporation Commission
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Chief Counsel
Legal Division
Arizona Corporation Commission
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Residential Utility Consumer Office
1110 West Washington Street
Suite 220
Phoenix, Arizona 85007


By: Alexandra Treloar

Arizona Business Gazette

The business resource

**PUBLIC NOTICE
OF AN APPLICATION FOR AN
ORDER AUTHORIZING THE
ISSUANCE OF UP TO \$174
MILLION IN LONG-TERM DEBT
BY ARIZONA-AMERICAN
WATER COMPANY**

Arizona American Water Company filed an application with the Arizona Corporation Commission (Commission) for an order authorizing Applicant to issue up to \$174 million of long-term debt. The application is available for inspection during regular business hours at the office of the Commission at 1200 West Washington, Phoenix, Arizona 85007, and the Company's offices in 19820 N. 7th Street, Suite 201, Phoenix, Arizona 85024.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon Applicant and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.

2. A short statement of the proposed intervenor's interest in the proceeding.

3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.

4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.

The granting of Motions to Intervene shall be governed by A.R.C. 214-3-105, except that all Motions to Intervene must be filed on or before the 15th day after this notice.

Published: May 18, 2006

PO BOX 194
Phoenix, Arizona 85001-0194
(602) 444-7315 FAX (602) 444-7364

STATE OF ARIZONA
COUNTY OF MARICOPA

} SS.

Ondrea Sheppard, being first duly sworn, upon oath deposes and says: That she is the marketing/advertising lead of the Arizona Business Gazette, a newspaper of general circulation in the county of Maricopa, State of Arizona, published weekly at Phoenix, Arizona, and that the copy hereto attached is a true copy of the advertisement published in the said paper on the dates indicated.

5/18/2006

Sworn to before me this
18TH day of
MAY 2006



Ondrea S.C.

Marilyn Greenwood
Notary Public

AFFIDAVIT OF PUBLICATION

STATE OF ARIZONA
COUNTY OF SANTA CRUZ } ss.

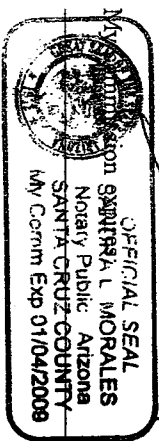
MANUEL COPPOLA being of first duly sworn,
deposes and says: that he/she is PUBLISHER
of the NOGALES INTERNATIONAL, a newspaper
published in the County of Santa Cruz, State of Arizona,
and of general circulation in said County, State and
elsewhere, and that the hereto attached legal notice
PUBLIC NOTICE AZ WATER CO

was printed and published correctly in the regular and
entire issue of said NOGALES INTERNATIONAL for
the 1 issues; that the first publication was made on
the 19 day of MAY, 20 06, and the
last publication thereof was made on the 19 day of
MAY, 20 06.

NOGALES INTERNATIONAL

By Manuel Copola
Subscribed and sworn to before me this 19
day of MAY, 20 06.

Notary Public



PUBLIC NOTICE

OF AN APPLICATION FOR AN ORDER AUTHORIZING THE ISSUANCE OF UP TO \$174 MILLION IN LONG-TERM DEBT BY ARIZONA-AMERICAN WATER COMPANY

Arizona-American Water Company filed an Application with the Arizona Corporation Commission (Commission) for an order authorizing Applicant to issue up to \$174 million of long-term debt. The application is available for inspection during regular business hours at the office of the Commission at 1200 W. Washington, Phoenix, Arizona 85007, and the Company's offices in 19820 N. 7th Street, Suite 201, Phoenix, Arizona 85024.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum, shall contain the following information:

The name, address, and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.

A short statement of the proposed intervenor's interest in the proceeding.

Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.

A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.

Proof of Publication

STATE OF ARIZONA }
County of Mohave } ss.

Linda Delano, being first duly sworn, says that during the publication of the notice, as herein mentioned, he/she was and now is the Legal Clerk of the MOHAVE VALLEY DAILY NEWS, six times weekly newspaper published on Sunday, Monday, Tuesday, Wednesday, Thursday and Friday of each and every week at the city of Bullhead City, in said county.

That said newspaper was printed and published as aforesaid on the following dates, to-wit:

May 15, 2006

**PUBLIC NOTICE
OF AN APPLICATION FOR AN ORDER
AUTHORIZING THE ISSUANCE OF UP TO \$174 MILLION IN
LONG-TERM DEBT
BY ARIZONA-AMERICAN WATER COMPANY**

Arizona-American Water Company filed an Application with the Arizona Corporation Commission (Commission) for an order authorizing Applicant to issue up to \$174 million of long-term debt. The application is available for inspection during regular business hours at the office of the Commission at 1200 W. Washington, Phoenix, Arizona 85007, and the Company's offices in 19820 N. 7th Street, Suite 201, Phoenix, Arizona 85024.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum, shall contain the following information:

1. The name, address, and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.

That the Public Notice

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.
Publish: May
16554142

of which the annexed copy is a printed and true copy, was printed and inserted in each and every copy of said newspaper printed and published on the dates aforesaid, and in the body of said newspaper and not in a supplement thereto.

Subscribed and sworn to before me this 24th
day of May, 2006

Susan L. Anderson

Notary Public

(My commission expires

July 14, 2007

